No. 10,505

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

LINDA H. HALE,
Appellant,

vs.

CLIFFORD C. ANGLIM, Individually, and as Collector of Internal Revenue for the First District of California,
Appellee.

APPELLANT'S OPENING BRIEF.

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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JURISDICTIONAL STATEMENT.

This is an appeal from a judgment of the District Court of the United States for the Northern District of California, Southern Division.

This action in the District Court was for the recovery of Federal Income Taxes erroneously and illegally collected from Appellant (R. 3, 4, 6, 7). Claim for Refund of said Federal Income Taxes was filed by Appellant but said Claim for Refund was rejected by the Commissioner of Internal Revenue (R. 7). This action for the recovery of said taxes was brought in the District Court pursuant to Section 24 (5) of the Judicial Code as amended; United States Code, Title 28,

Section 41 (5). The matter came to trial on February 9, 1943 and the judgment of the District Court was entered in favor of Appellee on May 13, 1943 (R. 25). On June 18, 1943, under authority of Section 128(a) of the Judicial Code, as amended; United States Code, Title 28, Section 225, appeal was taken to this Court to review the judgment of the District Court (R. 66). This appeal and the transcript of record were filed and docketed in this Court on July 26, 1943 (R. 69). The existence of jurisdiction in the District Court is set forth in Paragraph II of Appellant's Complaint (R. 2, 3).

STATEMENT OF THE CASE.

Appellant is the surviving wife of Prentis Cobb Hale, Sr. (R. 4). Prentis Cobb Hale, Sr. died testate on November 21, 1936, and his Will, which was admitted to probate (R. 4), provided among other things that:

> (a) He believed and declared all of his property was his own separate property but that if any of his property should be found to be community property and his wife (Appellant herein) should elect to take any portion thereof under the community property laws of California, then the property thereafter in the Will which was set apart in trust for Appellant during her lifetime should be reduced by the appraised value of the property which Appellant might elect to take as community property (R. 44, 45), and

(b) The sum of $10,000.00 in cash and all automobiles owned by the testator be given to Appellant (R. 45), and

(c) Certain real and personal property be distributed to a trustee to be held in trust for the use and benefit of Appellant (R. 45); the *net income* of the trust fund to be paid to Appellant during the term of her natural life (R. 47), and

(d) Subject to certain contingencies not here material, the residue of the trust property held by the Trustee on the termination of the trust, together with all of the other property of the estate of Prentis Cobb Hale, Sr. which remained for final distribution after the payment of debts and satisfaction of specific bequests was given and bequeathed to Prentis Cobb Hale, Jr., the son of Appellant (R. 48, 49).

Subsequent to the death of her husband, Appellant claimed that a large portion of the property of her husband's estate was community property and that under the laws of the State of California, she was entitled to one-half of such property (Paragraph V of Complaint, R. 5). This claim of Appellant was resisted by Prentis Cobb Hale, Jr. In order to settle the controversy amicably and without resort to litigation, an agreement was executed, dated June 18, 1937 (R. 37, 38, 39). The agreement recites that it is being executed for the purpose of settling, without litigation, the controversy between Appellant and Prentis Cobb Hale, Jr. and that the parties accept the sum of

$340,000.00 as the fair net value of the one-half interest of Appellant in the community property of Prentis Cobb Hale, Sr. (R. 39). Pursuant to Article 1 of this agreement, Appellant received outright and without any trust restrictions certain real and personal property (R. 40, 41) which otherwise by the terms of Article Thirteenth of the Will of Prentis Cobb Hale, Sr. (R. 45, 46) would have been distributed to a certain Trustee to pay the net income therefrom to Appellant during the term of her natural life with remainder over to Prentis Cobb Hale, Jr. (R. 47, 48).

Pursuant to Article 3 of the agreement of June 18, 1937, there was distributed to Prentis Cobb Hale, Jr., outright and without any trust restrictions 6,000 shares of Transamerica Corporation stock (R. 41) which otherwise by the terms of Article Thirteenth of the Will of Prentis Cobb Hale, Sr. would have been distributed to a Trustee to pay the net income to Appellant during the term of her natural life and with remainder over to Prentis Cobb Hale, Jr. (R. 47, 48).

As a consequence of the above described transfers of property to Appellant and Prentis Cobb Hale, Jr. under the agreement of June 18, 1937, there remained for distribution to the Testamentary Trustee out of the property originally intended by the Testator to be held in trust, only the following, to-wit:

(a) 10,000 shares of Hale Bros. Stores and
(b) 50 shares of Hale Real Estate Company.

These two groups of securities were distributed by the Estate of Prentis Cobb Hale, Sr. to the Testamentary Trustee on July 29, 1937 (R. 57).

A summary showing the property bequeathed in Trust by Article Thirteenth of the Will of Prentis Cobb Hale, Sr. and showing also how such property and income therefrom was actually distributed pursuant to the agreement of June 18, 1937 is set forth in tabular form in Exhibit A (Appendix i).

In addition to making provision for a distribution of a portion of the securities which otherwise would have become a part of the Testamentary Trust, the parties to the agreement also agreed upon an allocation of the income which had been received by the Estate of Prentis Cobb Hale, Sr. on the securities during the interval between the date of death of Mr. Prentis Cobb Hale, Sr. on November 21, 1936 and the date of the agreement of June 18, 1937 (R. 42, 43). The agreement of June 18, 1937 in this respect provided in substance that:

(a) All dividends theretofore received by the Estate of Prentis Cobb Hale, Sr. on the shares of stock to be distributed to Appellant under paragraph 1 of the agreement (R. 40) should be paid by the Estate to Appellant (Article 8 of agreement, R. 42); and

(b) All dividends theretofore received by the Estate of Prentis Cobb Hale, Sr. on the 6,000 shares of Transamerica Corporation stock to be distributed to Prentis Cobb Hale, Jr. under paragraph 3 of the agreement (R. 41) should be paid by the Estate to Prentis Cobb Hale, Jr. (Article 9 of agreement, R. 43).

As a consequence of the provisions of Articles 8 and 9 of the agreement of June 18, 1937 (R. 42, 43), there was distributed:

(a) To Appellant, the sum of $5750.00 cash and 40 shares of Bancamerica Blair Co. stock valued at $12.00 per share or $480.00, making a total distribution to Appellant of $6230.00 (R. 36, 61, 62) and

(b) To Prentis Cobb Hale, Jr., dividends on 6,000 shares of Transamerica Corporation stock (R. 43).

The amount of $6230.00 which Appellant received from the Estate of Prentis Cobb Hale, Sr. under the provisions of Article 8 of the agreement of June 18, 1937 was reported by Appellant as taxable income from a Fiduciary in her individual income tax return for the calendar year 1937 and thereafter Appellant paid the amount of Federal Income Tax applicable thereto (Par. IV, Complaint, and Par. VII, Findings, R. 3, 23, 24).

The dividends on 6,000 shares of Transamerica Corporation stock which were distributed to Prentis Cobb Hale, Jr. under Article 9 of the agreement of June 18, 1937 were nevertheless reported in the Federal Income Tax Return of the Estate of Prentis Cobb Hale, Sr. (R. 59).

Appellant filed a claim for refund of the taxes paid by her, applicable to said sum of $6230.00 and on November 12, 1941 the Commissioner of Internal Revenue rejected Appellant's claim (R. 7, 32).

In addition to the sum of $6230.00 received by Appellant as heretofore described, Appellant also received and reported as taxable income in the year 1937, the sum of $5450.00 (R. 50). This sum was received from the Testamentary Trustee under the Trust created by Article Thirteenth of the Will of Prentis Cobb Hale, Sr. as modified by the agreement of June 18, 1937 (Par. VI, Complaint, R. 6, 36). The amount of $5450.00 represented dividends received by the Estate of Prentis Cobb Hale, Sr. during the period from the date of death of Prentis Cobb Hale, Sr. (November 21, 1936) to the date the securities ultimately forming a part of the Testamentary Trust were distributed to the Trustee, namely, July 29, 1937 (R. 36; Article 2 of Agreement June 18, 1937, R. 41). These dividends may be summarized as follows:

(a) On 10,000 shares of Hale Bros. Stores, Inc.	$5000.00
(b) On 50 shares of Hale Real Estate Company	450.00
(c) Total	$5450.00

The claim for refund filed by Appellant and heretofore referred to (R. 7, 32) which was rejected by the Commissioner of Internal Revenue, also included a claim for the refund of Federal Income Taxes applicable to the said sum of $5450.00 reported by Appellant as taxable income.

Upon the facts as hereinbefore stated and which are also set forth in the Findings of Fact (R. 19-24) the

District Court concluded that the amounts of $6230.00 and $5450.00 so distributed by the Estate of Prentis Cobb Hale, Sr. and the Testamentary Trustee respectively to Appellant were properly reported by Appellant as taxable income and judgment was accordingly entered for the defendant on May 13, 1943 (R. 25).

THE QUESTIONS INVOLVED.

The first question involved on this appeal is the legal status of the amount of $6230.00 received by Appellant under Article 8 (R. 42) of the agreement of June 18, 1937, namely, whether such amount in the hands of Appellant represents:

(a) Taxable income to Appellant as held by the District Court, or

(b) Receipt of property to compromise contemplated litigation by Appellant as an heir to her husband's estate or in partial settlement of Appellant's interest as a surviving wife in the community estate of her husband, in either of which cases the proceeds received by Appellant would be exempt from Federal Income Tax under Section 22 (b) (3) of the Revenue Act of 1936 (Appendix p. ii) in the hands of Appellant but would be taxable income to the Estate of Prentis Cobb Hale, Sr.

The second question involved on this appeal is whether the sum of $5450.00 which was received by Appellant from the Trustee of the Testamentary Trust

is properly considered taxable income to Appellant in the year 1937 as held by the District Court or whether it represents the distribution to Appellant of an amount to which Appellant was not entitled under the law of the State of California and which amount therefore should be included in the taxable income of the Estate of Prentis Cobb Hale, Sr. for the year 1937 instead of in the taxable income of Appellant.

SPECIFICATION OF ERRORS.

The following is a list of the errors which Appellant contends were committed by the District Court and upon which errors Appellant relies on this appeal:

(1) The determination of the District Court that the executors of the Will of Prentis Cobb Hale, Sr. and the Testamentary Trustee were, under the terms of the Will, authorized to credit and distribute to Appellant both the items of $6230.00 and $5450.00 heretofore mentioned (Findings, R. 24).

(2) The determination of the District Court that the executors of the Will of Prentis Cobb Hale, Sr. were entitled to deduct from the income tax return of the Estate the amount of $6230.00 and $5450.00 heretofore mentioned and that the Estate of Prentis Cobb Hale, Sr. was not required to pay income taxes upon them (Findings, R. 24).

(3) The determination of the District Court that Appellant was the person properly receiving

such distributions and was accordingly required under Section 162(c) of the Revenue Act of 1936 to return these amounts as her income and to pay the taxes upon same (Findings, R. 24).

(4) The District Court erred as a matter of law in failing to find that the sum of $6230.00 was received by Appellant under the agreement of June 18, 1937 in settlement of contemplated litigation or in partial settlement of Appellant's community interest in the estate of her deceased husband.

(5) The District Court erred as a matter of law in failing to find that under the law of the State of California in effect during the time here involved, the income accruing on the trust property during the period intervening between the date of death and the date of distribution of the property to the Testamentary Trustee belongs to the Estate of the Decedent and not the person entitled to the income of the Testamentary Trust (Appellant herein).

THE STATUTES INVOLVED.

Sections 22 (b) (3) and 162 (c) of the Revenue Act of 1936 are set forth in the Appendix hereto.

SUMMARY OF ARGUMENT.

(1) The amount of $6230.00 which is admitted by all parties to be income to the Estate of Prentis Cobb Hale, Sr. when originally received became merely part and parcel of Appellant's compromise settlement of her interest as an heir of her husband's estate when it was distributed to her in the same manner that dividend income of an estate may be used to pay a creditor's claim or repay a loan without being regarded as taxable income to the recipient.

(2) The amount of $6230.00 represents dividends received by the Estate of Prentis Cobb Hale, Sr. intervening between the date of Mr. Hale's death and the agreement of June 18, 1937. It is taxable to the Estate of Prentis Cobb Hale, Sr. in exactly the same manner as the dividends on the 6,000 shares of Transamerica stock distributed to Prentis Cobb Hale, Jr. were treated (R. 59).

(3) When income is once received by a taxpayer, such as the $6230.00 received by the Estate of Prentis Cobb Hale, Sr. in this case, the incidence of the applicable income tax may not be transferred to another (Appellant herein) merely by an agreement assigning a sum of money corresponding in amount to the income received by the entity originally subject to tax.

(4) If the income of $6230.00 admittedly received by the Estate of Prentis Cobb Hale, Sr. in 1937 and distributed to Appellant in the same year had not been made the subject of an agreement until 1938 this amount of necessity would have been reported as taxable income by the Estate in 1937 and would have been

distributed to Appellant tax free in 1938. Why should the purely fortuitous circumstances of receipt by the Estate and payment to Appellant in the same taxable year result in a tax to Appellant whereas a distribution if postponed to January 2, 1938 would have resulted in the amount being taxed to the Estate of Prentis Cobb Hale, Sr. in 1937?

(5) With respect to the dividends of $5450.00 which were received by the Estate of Prentis Cobb Hale on the trust property subsequent to the death of Mr. Hale and prior to distribution of the trust property to the Trustee, the law of California during the period here in question is that an income beneficiary is not entitled to any income accruing prior to the distribution of the trust property to the Testamentary Trustee because until the trust property is formally distributed to the Testamentary Trustee there is no trust in existence and hence there can be no trust income to distribute.

ARGUMENT.

1. INTRODUCTORY STATEMENT.

It is admitted by Appellant that the two sums here involved, namely, $6230.00 and $5450.00 represent income which is taxable to some taxpayer in the year 1937. The question is whether these amounts are for Federal Income Tax purposes properly taxable to Appellant or to the Estate of Prentis Cobb Hale, Sr. The two amounts were received by Appellant under circumstances which are materialy different and ac-

cordingly this argument will be presented in two parts, the first of which will relate to the sum of $6230.00 and the second, in which the amount of $5450.00 will be discussed.

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2. TERMS OF AGREEMENT OF JUNE 18, 1937 AS COMPARED WITH PROVISIONS OF WILL.

Appellant contends that the amount of $6230.00 was received by her as an integral part of the settlement of her asserted community property interest in the estate of her husband and on the contrary that Appellant did not receive the sum of $6230.00 as income from the estate of her husband. The purpose and intention of the parties in executing the agreement of June 18, 1937 is stated to be:

> "* * * For the purpose of compromising and settling without litigation, the said controversy between the said Linda Hoag Hale and the said Prentis Cobb Hale, Jr. * * *" (R. 39).

The entire agreement must be regarded as having been executed for that purpose and not merely Article 1 thereof by the terms of which Appellant received certain real and personal property (R. 40). Article 8 is just as much a part of the contract as Article 1 and Article 8 provides that in addition to the property to be distributed to Appellant under Article 1, Appellant shall be entitled to receive:

> "* * * All dividends heretofore declared by the respective corporations, or by any thereof, hereinabove in the said paragraph 1 of this agreement named, * * * heretofore paid to and received by

> the said executrix and the said executors of the said last will and testament * * *'' (R. 42).

In other words, the measure of Appellant's community interest in the estate of her deceased husband was, by the terms of this agreement, determined to be an amount equal in value to the real property and securities referred to in Article 1 of the agreement (R. 40) plus the dividends theretofore received by the estate upon the shares distributed to Appellant under Article 1. This provision of the agreement relating to distributing to Appellant the dividends on the shares listed in Article 1 has the same effect as if, in Article 1, the parties had stated that Appellant should be entitled to receive the properties therein described, together with the sum of $6230.00. Instead of determining accurately at the time of drafting the agreement the amount of dividends which had been theretofore paid to the executors of the estate and using this specific figure as an additional measure of Appellant's community property interest the agreement merely provided that Appellant should be entitled to such dividends in whatever amount they might be. Putting the matter another way, the estate was discharging an asserted liability to Appellant by distributing three types of property, namely, (1) real property, (2) personal property and (3) an indeterminate sum to be measured by the income from some of the property so distributed.

If reference is made to the Will of Prentis Cobb Hale, Sr. to ascertain whether Appellant had any rights with respect to the amount of $6230.00 here in

controversy, it will be seen that there is no provision in the Will directing this amount to be paid to Appellant. The nearest approach to any such provision in the Will is to be found in Article Thirteenth of said Will (R. 45, 47) in which it is provided that Appellant shall be entitled to the *net income* of certain property which is bequeathed to a Testamentary Trust. This property, instead of ultimately forming a part of the Trust, was, as heretofore stated, distributed to Appellant under the agreement of June 18, 1937. If the contention is made that Appellant was already entitled to the $6230.00 by reason of the provisions of Article Thirteenth of the Will, the answer to such contention is that the agreement gave to Appellant not an item of *net* income but instead the *gross* amount of certain dividends without any deduction for any expenses. In other words, the agreement gave to Appellant the right as a creditor to demand and receive certain specific dividends wholly without regard to whether, by reason of any losses, expenses or other causes, there remained any trust net income to distribute. That is to say, by the terms of the agreement of June 18, 1937, Appellant's interest in the estate of her deceased husband was translated from that of an heir entitled to an interest in the *net income* of certain trust securities to that of a creditor entitled to enforce a demand for certain specific items of *gross income* and wholly without regard to whether any trust net income existed or not.

If, as has been intimated by the opinion of the District Court, Appellant was entitled as a matter of

law to receive the sum of $6230.00, then the inclusion of detailed provisions for the payment of this sum to Appellant in Article 8 of the agreement was a wholly unnecessary and idle act. Certainly the parties to the agreement did not share that opinion at the time the agreement was executed. It is equally certain that the parties to the agreement of June 18, 1937 intended that Appellant should receive as a measure of and in settlement of her community interest and in the settlement of her general interest as an heir of the estate of her husband, not only the real and personal property described in Article 1 of the agreement but also the amount of the dividends referred to in Article 8 of the agreement.

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3. INCONSISTENCY OF TREATMENT OF DIVIDENDS ON SHARES RECEIVED BY APPELLANT AS COMPARED WITH DIVIDENDS ON SHARES RECEIVED BY HER SON.

It is in evidence that the shares of stock which were to be placed in the Testamentary Trust provided in Article Thirteenth of Mr. Hale's Will were divided into three parts. One portion of the shares was distributed to Appellant under Article 1 of the agreement; another portion (6,000 shares of Transamerica stock) was distributed to Appellant's son under Article 3 of the agreement; and a third portion of the securities ultimately was distributed as a part of the Testamentary Trust (R. 40, 41). It is also in evidence that the income intervening between the date of death and the agreement of June 18, 1937 on all of the securities which were originally intended to form a part of the

Testamentary Trust was likewise distributed in the same manner as the securities, namely, the Appellant received the income on the shares distributed directly to her (R. 42); her son received the income on 6,000 shares of Transamerica stock distributed to him (R. 43) and the dividends on the shares distributed to the Testamentary Trustee were paid to the Trustee and were subsequently distributed to Appellant by Trustee (R. 50).

It is also in evidence that the income which was received by the Estate of Prentis Cobb Hale, Sr. on the 6,000 shares of Transamerica stock distributed to Appellant's son was reported as taxable income by the said estate (R. 59). Appellant contends that the same treatment should be accorded her as was accorded her son, namely, that the income which was originally received by the estate of her husband on the securities distributed to her and to her son should be taxable to said estate as income received during the course of administration. There is no more basis in law for taxing the $6230.00 to Appellant than there would have been for taxing the income on the 6,000 shares of Transamerica stock for the corresponding period to Appellant's son.

If it was proper for the Estate of Prentis Cobb Hale, Sr. to report as taxable income the dividends on 6,000 shares of Transamerica stock distributed to Appellant's son under Article 9 of the agreement of June 18, 1937, then the Estate should also be taxable on similar dividends distributed to Appellant under the same agreement.

4. **INCOME IS NOT ORDINARILY CAPABLE OF ASSIGNMENT SO AS TO DEFEAT THE INCIDENCE OF TAX UPON THE ORIGINAL RECIPIENT OF SUCH INCOME.**

It is in evidence and admitted that the dividends of $6230.00 here in question were originally received by the estate of Prentis Cobb Hale, Sr. It is a fundamental rule in the law of income taxation that income cannot be assigned before it is received and thus defeat the tax on the assignor. See *Lucas v. Earl,* 50 S. Ct. 241, 281 U. S. 111, 74 L. Ed. 731, decided March 17, 1930. In *Lucas v. Earl,* husband and wife domiciled in California agreed that the future earnings of the husband thereafter would be held in joint tenancy. The question was whether Mr. Earl could by this means avoid reporting one-half of the income from his salary or earnings and cause it to be reported by his wife as taxable income. The United States Supreme Court, speaking through Justice Holmes, held that the tax applied to the person who earned the income and that this liability could not be escaped by an anticipatory arrangement involving an assignment of income. See also in this connection *Rosenwald v. Commissioner,* 33 Fed. (2d) 423, Seventh Circuit, decided June 7, 1929. In this case the Court held that the plaintiff could not, by an assignment of income to a charitable organization, be relieved of his liability to pay the tax on such income.

The point which it is desired to make in this connection is that the estate of Prentis Cobb Hale, Sr. cannot, by an assignment of income which has theretofore been received by the estate, transfer to Appellant

the liability for the payment of tax upon such income. The estate, as the original recipient of the income, is required to pay the tax thereon.

If it is urged that an estate, during the course of administration is entitled to deduct income paid or credited under Section 162(c) of the Revenue Act of 1936, the Appellant's answer is that Section 162(c) refers to distribution of income as such. Section 162(c) is set forth in full in the appendix but the portion thereof pertinent to this discussion is quoted herewith for ready reference:

> "* * * There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the *income* of the estate or trust for its taxable year which is properly paid or credited during such year to any legatee, heir or beneficiary * * *" (italics supplied).

The amount of $6230.00 which was admittedly income when received by the Estate of Prentis Cobb Hale, Sr. is not "Income" within the statute when distributed to Appellant either in settlement of her community interest or as a creditor entitled to the same under Article 8 of the agreement of June 18, 1937. For instance, if the $6230.00 were paid to Appellant in reimbursement of advances which she made on behalf of the estate of her deceased husband no one would contend that the $6230.00 so received by Appellant should be reported as taxable income. The fact that the $6230.00 was clearly income to the Estate of Prentis Cobb Hale, Sr. when received has no bearing

whatsoever in determining its status to Appellant for purposes of her income tax return. This point is particularly pertinent here when the agreement under which the amount was received by Appellant is designated clearly and unequivocally as an agreement

> "* * * for the purpose of compromising and settling, without litigation, the said controversy between the said Linda Hoag Hale and the said Prentis Cobb Hale, Jr., and to that end of establishing the fair net value of the said community property at the time of the death of the said Prentis Cobb Hale, Sr. * * *" (R. 39).

Consequently, the assignment of the amount of $6230.00 by the Estate of Prentis Cobb Hale, Sr. to Appellant in settlement of her community rights pursuant to the agreement of June 18, 1937 cannot have the effect of transferring to Appellant the incidence of the Federal Income Tax thereon under the decisions in such cases as *Lucas v. Earl,* 50 S. Ct. 241, 281 U. S. 111, 74 L. Ed. 731, and *Rosenwald v. Commissioner,* 33 Fed. (2d) 423, Seventh Circuit.

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5. APPELLANT RECEIVED THE SUM OF $6230.00 UNDER A DECREE OF RATABLE DISTRIBUTION.

It will be observed that Appellant in this case did not receive the sum of $6230.00 from the Testamentary Trustee created under Article Thirteenth of the Last Will and Testament of Appellant's husband but instead received this sum ($5750.00 in cash and 40 shares of Bancamerica Blair stock valued at $480.00) directly

from the executors of the estate of Prentis Cobb Hale, Sr. (R. 49, 50). This observation is intended to show that Appellant did not receive this money or property by reason of her interest under the Testamentary Trust created by Article Thirteenth of the last will and testament of her husband, but instead, received the said sum of $6230.00 solely as part and parcel of the amount of her claimed community interest. If the sum of $6230.00 represented a distribution of income from the Testamentary Trust to which Appellant was entitled as an heir, Appellant would not have received such sum until the Trust had been formally created by distribution to the Trustees, which event took place on July 29, 1937, just as was done with the sum of $5450.00 received by Appellant (R. 50).

The method of distribution of the sum of $6230.00 to Appellant further supports Appellant's contention that she received said sum in settlement of her rights as a creditor of the estate of her husband under the agreement of June 18, 1937 and not at all by reason of her interest as an heir under Article Thirteenth of the last will and testament of her husband. Reference is again made to the point that $6230.00 represents *gross* dividend income whereas Article Thirteenth of said will provides that Appellant would have been entitled to receive only *net* income (R. 47). It is unnecessary to point out the many different circumstances which could transpire to result in the absence of net income, even though the trust received a certain amount of gross income.

6. **THE DECISION IN LYETH v. HOEY, 59 S. Ct. 155, 305 U. S. 188, 83 L. Ed. 119, DECIDED DECEMBER 5, 1938.**

In the case *Lyeth v. Hoey,* a decedent died in 1931, a resident of Massachusetts and left as her heirs four living children and the Appellant and his brother who were the sons of a deceased child. The decedent gave certain small legacies to her heirs and the entire residue amounting to more than $3,000,000.00 was bequeathed to certain trustees under an endowment trust. The Appellant objected to the will of the Decedent upon the grounds of lack of testamentary capacity and undue influence. The Probate Court before which the will was being offered granted a motion for the framing of issues for a trial before a jury as to the question of whether the decedent had testamentary capacity. Thereafter, a compromise agreement was entered into between the heirs, the legatees and devisees under the will pursuant to which the Appellant received a substantial amount of property. The Commissioner of Internal Revenue attempted to tax the amount received by Appellant as taxable income. The Appellant contended that the amount received by him was exempt under Section 22(b)(3) of the Revenue Act of 1932 which exempted from income tax:

> "The value of property acquired by gift, bequest, devise or inheritance * * *"

There has been no change in the statute since the decision in *Lyeth v. Hoey* insofar as it relates to property received by gift, bequest, devise or inheritance. That is, Section 22(b)(3) of the Revenue Act of 1932

under which the case of *Lyeth v. Hoey* was decided, reads exactly the same as Section 22(b)(3) under which our present case arises.

In *Lyeth v. Hoey,* the United States Supreme Court held that property received by an heir under an agreement which had for its purpose the compromising of impending litigation with respect to a decedent's will constituted property received by inheritance under Section 22(b)(3) of the Revenue Act of 1932 and did not constitute taxable income. The opinion of the United States Supreme Court reads in part as follows (305 U. S. at page 196):

> "* * * There is no question that petitioner obtained that portion, upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity. It does not seem to be questioned that if the contest had been fought to a finish and petitioner had succeeded, the property which he would have received would have been exempt under the federal act. Nor is it questioned that if in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act. We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption * * *"

As has been pointed out heretofore, the statutory provisions involved in our present case are identical

with the statute as it existed in the case of *Lyeth v. Hoey*. Turning to a comparison between the facts of the two cases, we find:

(1) In the cited case the Taxpayer Appellant was an heir of the Decedent and it is likewise in our present controversy.

(2) There, as here, the Taxpayer Appellant contested the disposition of property made by Decedent's will.

(3) There, as here, a compromise agreement was entered into in order to avoid litigation.

(4) There, as here, the Taxpayer Appellant received certain property admittedly in compromise of the asserted claims.

(5) In each case the Treasury Department asserted a right to tax the property received as income instead of exempting it as property received by inheritance.

It is admitted in the pleadings that Appellant received the sum of $6230.00 under the terms of Article 8 of the agreement of June 18, 1937 (Complaint, paragraphs IV and V (R. 3-5), and Answer, paragraphs II and III thereof (R. 8, 9)). Appellant therefore contends that both the facts and the law involved in *Lyeth v. Hoey* are directly applicable to Appellant's case and that the decision here should be correspondingly in Appellant's favor insofar as her case refers to the sum of $6230.00.

It is also observed in this connection that it has never been contended that the securities and real estate received by Appellant under the agreement of June 18,

1937 were subject to income tax in her hands. The sum of $6230.00 is in exactly the same category since it is merely a part of the settlement price formally agreed upon as a measure of the value of the community property interest in Decedent's estate to which Appellant was entitled.

It is also Appellant's belief that a considerable part of the difficulty in this case arises from the failure to distinguish between the intention of the parties with respect to the payment of said sum of $6230.00 and the use of the word "dividends" in Article 8 of the agreement of June 18, 1937 (R. 42). Dividends ordinarily connote income. It is clear, however, that dividends once received by a taxable entity such as the estate of Prentis Cobb Hale, Sr. lose their identity as income when distributed by the original taxable entity in liquidation of a contractual obligation. Appellant does not contend that the sum of $6230.00 should escape taxation; Appellant does contend that $6230.00 should be taxed to the estate by which it was received.

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7. DISTRIBUTION OF $6230.00 TO APPELLANT MADE IN YEAR OF ITS RECEIPT BY ESTATE OF PRENTIS COBB HALE, SR.

Dividends amounting to $6230.00 were received by the Estate of Prentis Cobb Hale, Sr. in 1937 (R. 36) and the amount of $6230.00 was paid to Appellant in the year 1937 (R. 50, 61, 62). The purely fortuitous circumstance of distributing the $6230.00 to Appellant in the year of its receipt by the Estate of Prentis Cobb Hale, Sr. provides a seeming plausibility to the con-

tention that the said $6230.00 should be regarded as taxable income of the Appellant for the year of its receipt by Appellant, namely, the year 1937. However, further analysis will show that the apparent propriety of regarding the amount of $6230.00 as taxable to Appellant in 1937 arises solely out of the coincidence of the receipt and distribution of such amount within one taxable year.

In illustration of Appellant's point in this connection, let us assume that instead of settling Appellant's claim amicably by the agreement of June 18, 1937, Appellant had been required to litigate the issue. Assume further that the litigation was commenced in 1937 and concluded by a final decision in 1942 under which decision, let us assume further, that Appellant received exactly the same property, including the $6230.00 that was distributed to her under the agreement of June 18, 1937. Could any one successfully contend that the Federal income tax applicable to the sum of $6230.00 should be deferred until the calendar year 1942, when, in point of fact, the income was actually received by the estate in the year 1937? It is fundamental that the Federal income tax law requires returns of income to be made on an annual basis and requires that the tax be paid on a similar basis. If the matter here at issue had proceeded to litigation, there is no question concerning the fact that the estate of Decedent would have reported the dividend income of $6230.00 in the year of its receipt and would have paid the Federal income tax applicable thereto in the usual manner. It is also clear that if

the Appellant had secured a judgment in 1942 in the manner previously assumed, the estate would have disbursed the $6230.00 together with the other property in liquidation of its liability to Appellant in the same manner that any other money or property of the estate would be paid to a creditor in settlement of a claim.

Further, it is pointed out in this connection that no distinction can be drawn between the principle under which Appellant received property pursuant to a property settlement agreement as compared with a receipt of property as a result of litigating her rights under the will because the United States Supreme Court said in *Lyeth v. Hoey,* 59 S. Ct. 155, 305 U. S. 188, 83 L. Ed. 119 (305 U. S. at page 196):

> "* * * We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption * * *"

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8. ARTICLE FOURTH OF WILL OF PRENTIS COBB HALE, SR.

Heretofore in this brief, Appellant has proceeded upon the theory that the sole basis for her claim to the sum of $6230.00 was the compromise agreement of June 18, 1937. Appellant submits that while it is true she received the said sum under and pursuant to the compromise agreement, basically and fundamentally, it can also be argued that the amount of

$6230.00 was received by her as an heir under Article Fourth of her husband's Will and that the agreement which provided for distribution of this amount was executed merely for the purpose of carrying out the provisions of Article Fourth of the Will. Article Fourth reads as follows:

> "I believe and declare that all property which I own, or in which I have any interest, is my own separate property, but if any property in which I may be interested at the time of my death shall be found to be community property, and if my said wife shall elect to take any portion thereof under the community property laws of this State, then I direct that the property and estate hereinafter set apart in trust for her use during her lifetime be reduced in amount by the appraised value of the community property and estate which she shall elect to take." (R. 44, 45.)

Under Article Fourth of her husband's Will, Appellant had the right to prove the amount of community property to which she was entitled and by the specific terms of the Will, Appellant was entitled to receive such amount of community property out of the assets otherwise bequeathed to the Testamentary Trust. Appellant therefore contends that even if the argument heretofore advanced by Appellant to the effect that she took the $6230.00 as a creditor is not conceded, certainly the provisions of the Will are specific to the effect that Appellant was entitled to receive as an heir such portion of her husband's property as could be proved to be community in character. Appellant's position may therefore be described as

that of an heir establishing the amount of her community property under the specific provisions of her husband's Will and then immediately upon the determination of the amount thereof her position was transformed into the status of a creditor by reason of a specific agreement on the part of the estate to assign and deliver specified parcels of real and personal property.

To summarize then, Appellant contends that whether we view the agreement of June 18, 1937 as a compromise of her rights as an heir to contest the Will of Prentis Cobb Hale, Sr. or whether we view the receipt by Appellant of the property here involved as being under the provisions of Article Fourth of the Will with the agreement merely ancillary or for the purpose of defining Appellant's particular rights, the conclusion is the same, namely, that Appellant received the sum of $6230.00 together with other property not as income but as settling Appellant's rights as an heir.

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9. THE OPINION FILED IN THE DISTRICT COURT.

Speaking with respect to the $6230.00 received by Appellant from the Estate of her husband, the opinion states in part (R. 16):

> "* * * The income derived from property held in trust relates back to the date of testator's death. Its status is fixed at that time, and the beneficiary is entitled to income derived from the specific property placed in trust * * *. A specific bequest

> carries with it all accessions by way of dividends or interest that may accrue after the death of the testator * * *."

It is thus clear that the Court was of the opinion that as a matter of law and independently of the agreement of June 18, 1937, Appellant was entitled to receive the $6230.00 and that she received the same as income. Appellant contends that the following listed California authorities clearly establish the law of this State to be to the contrary as of the date of the distributions here involved:

Clayes v. Nutter, 49 Cal. App. 148, 192 Pac. 870 (Decided August 30, 1920);

Estate of Brown, 143 Cal. 450, 77 Pac. 160 (Decided June 3, 1904).

In the case of *Clayes v. Nutter,* the will gave all of the estate to certain persons as trustees with authority to invest and manage the same and to pay out of the profits thereof the sum of $50.00 per month to a sister of the testatrix during her natural life. The Court held that the direction to pay the income to the sister of the testatrix in the absence of an express provision in the will making such a bequest of income payable from date of death did not entitle the life beneficiary to receive any payments during the time the estate was in the course of administration or prior to the date it was distributed to the trustees. This case is a clear authority for the proposition that income from a testamentary trust under the laws of the State of California does not accrue to the life

tenant in the interval from the date of death to the date the trust property is distributed to the trustees.

In the case of the *Estate of Brown,* the will bequeathed a fund of $5000.00 to trustees to be invested and out of the income arising therefrom to pay monthly to the sisters of the testatrix the sum of $20.00 during the natural life of the life tenant. The question arose as to whether this income was payable from the date of death or from the date the property was distributed to the trustees. The Court held directly that the income did not become payable to the life tenant until the trust property was distributed to the trustees, and stated (77 Pac. at page 162):

> "* * * The testatrix bequeathed the sum of $5000.00 to certain trustees, and the monthly income was to be paid by the trustees, and not by the executors. Necessarily, the trustees could not begin payment until they received the fund and invested it so as to produce an income. The intention of the testatrix must therefore have been that payments were not to begin until the fund from which it was to be produced was distributed to the trustees who were to make the payments. The distinction is thus stated: 'Where he absolutely gives the beneficiary a given income, and merely indicates in his will the source from which it is to be obtained, the general rule is that the income in such cases is to be estimated from the death of the testator * * *. But where the bequest is only of the income to be obtained from a certain specified fund, * * * it is held that the beneficiary can receive only the actual income when received from such fund' * * *."

The two decisions above referred to establish the rule to be that in California the income from a testamentary trust does not accrue to the life tenant until the trust property is distributed to the testamentary trustee. Of course, an exception exists in the event the trust can be established to be a trust for support and maintenance. In Appellant's case, however, no such situation existed because it is in evidence that appellant was currently receiving $1500.00 per month by way of a family allowance from the estate of her husband (R. 44) and also that her net income as shown by her individual Federal income tax return for the calendar year 1937 was $57,016.73 (R. 64). The authorities cited in the opinion of the District Court (R. 16) in support of its judgment that the life tenant is entitled to the income from a testamentary trust from the date of death of the decedent do not apply under the law of the State of California as it existed at the time here involved.

The following cases are cited in the opinion of the Court in support of its conclusion that the income from the property bequeathed in trust related back to the date of the testator's death and that the income beneficiary (Appellant herein) was entitled to the income accruing thereon after the death of the testator:

McCaughn v. Girard Trust Co., 19 F. (2d) 218;
Estate of White, 41 Bd. of Tax App. 525;
Estate of Fox, 31 Bd. of Tax App. 1181;
Estate of Daly, 202 Cal. 284, 260 Pac. 296.

The case of *McCaughn v. Girard Trust Co.,* 19 F. (2d) 218, related to a case in which the testamentary trust was held by the state Court (Maine) to be invalid and that as a consequence the income received from the date of death was taxable to the heirs entitled to the residuary estate. It is not apparent how the decision in this case supports the Court's conclusions with respect to the rule as to the right of an income beneficiary to trust income under the California rule adopted in the cases of *Clayes v. Nutter* and *Estate of Brown* heretofore cited.

The *Estate of White,* 41 Bd. of Tax App. 525 concerned a trust for the "Education and maintenance of my grandson". It is admitted by Appellant that in this type of trust the income accrues to the life tenant from the date of death but it is observed that this is not the type of trust involved in our present case. As has heretofore been shown our trust is not a trust for maintenance because Appellant had a substantial income from other sources (R. 63, 64).

Estate of Fox, 31 Bd. of Tax App. 1181, referred to an instance of the distribution of capital gains arising after the date of death. This type of profit was made the subject of a special agreement between the parties and, accordingly, the decision does not relate to the question as to who is entitled as a matter of law to the income from a testamentary trust during the interval between the date of death and the date of the creation of the testamentary trust.

In the *Estate of Daly,* 202 Cal. 284, 260 Pac. 296, the California Court held that a surviving wife to

whom had been bequeathed outright certain shares of stock, was entitled to the dividends thereon which accrued in the interval between the date of death and the date of the creation of a testamentary trust in which the wife apparently had no interest. In other words, this case is not concerned with the income accruing to a life tenant during the interval between the date of death and the date of the creation of the trust but instead is concerned solely with a determination of the question as to whether a person to whom specific securities have been devised outright and free of trust is entitled to the income therefrom from the date of death. Appellant submits that the decision in the cited case is not pertinent to a decision in the present case involving the income from property bequeathed in trust.

The opinion of the District Court dismisses the authorities submitted by Appellant (*Clayes v. Nutter,* 49 Cal. App. 148, 192 Pac. 870 and *Estate of Brown,* 143 Cal. 450, 77 Pac. 160) with the comment that

> "* * * The cases cited are not in point and Plaintiff's position is untenable * * *" (R. 18).

Appellant very respectfully suggests that the above mentioned cases cited by her are directly in point and directly bear on the question as to who under California law at the time here involved was entitled to receive the income from property bequeathed in trust during the interval between the date of death and the date said property is distributed to the testamentary trustee.

10. THE AMOUNT OF $5450.00 RECEIVED BY APPELLANT FROM TESTAMENTARY TRUSTEE.

As heretofore stated, the amount of $5450.00 represents dividends received by the estate of Prentis Cobb Hale, Sr. prior to the distribution to the Testamentary Trustee of certain securities specified in the Trust created by Prentis Cobb Hale, Sr. It is Appellant's position with respect to these dividends that under the decisions of the Supreme and Appellate Courts of this state heretofore in this brief referred to, namely, *Clayes v. Nutter,* 49 Cal. App. 148, 192 Pac. 870, and *Estate of Brown,* 143 Cal. 450, 77 Pac. 160, these dividends cannot be regarded as income of such Testamentary Trust because until the Trust comes into existence, it can receive or obtain no income (ante, this Brief, pages 30 to 32). That is, the securities from which these dividends were received were distributed to the Trustee by the Probate Court on or about July 29, 1937 (R. 57). The dividends amounting to $5450.00 had been received by the executors prior to July 29, 1937 and constituted income of the estate, not the Testamentary Trust. Accordingly, until the Court by a decree of distribution on July 29, 1937 created the Testamentary Trust, no Trust existed and consequently, it cannot be said that Appellant, who subsequently received these dividends, received them as a distributee of the Testamentary Trust.

In short, Appellant cannot be said to have received income from a Trust which had no legal existence at the time said dividends were received by the execu-

tors. If Appellant was not entitled, as a matter of law, to receive the dividends of $5450.00 from the Testamentary Trustee, the fact that she did receive such sum does not render it taxable to her as income under the decision in *Freuler v. Helvering,* 291 U. S. 35, 54 S. Ct. 308, 78 L. Ed. 634. In the last cited case the trustee under a testamentary trust made no deduction for depreciation in determining the net income distributable to the beneficiaries and accordingly distributed a greater amount of net income than would have been distributed if depreciation had been deducted. The California Probate Court held that such distribution was erroneous to the extent that depreciation was not deducted and the question was whether the trust income beneficiaries were taxable on the total amount distributed to them or only on the amount which should have been distributed. The United States Supreme Court held that the fact that the beneficiaries actually received and retained a greater amount of money than that to which they were entitled did not render them taxable on such amount. The Court said in the course of its opinion (291 U. S. 35 at page 42):

> "* * * the test of taxability to the beneficiary is not receipt of income, but the present right to receive it. Clearly an overpayment to a beneficiary by mistake of law or fact, would render him liable for the taxable year under consideration, not on the amount paid, but on that payable * * *"

In other words, the mere fact of receipt by Appellant of the $5450.00 does not render it taxable to her. In addition to being received by her, it must have

been distributed to Appellant as income to which Appellant was legally entitled. Since the California authorities heretofore cited (ante this Brief, pages 30 to 32) establish the rule in California as of the time herein involved to be that the life tenant under a Testamentary Trust is not entitled as a matter of law to the income on the trust property intervening between the date of death and the creation of the trust it follows that under the decision of the U. S. Supreme Court in *Freuler v. Helvering,* 291 U. S. 35, the amount of $5450.00 is not taxable income to Appellant even though received by her.

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11. SUMMARY.

Appellant's position with respect to the amounts here involved may be summarized as follows:

(1) As to dividends amounting to Six Thousand Two Hundred Thirty ($6230.00) Dollars, this sum represents an integral part of the total settlement received by Appellant in lieu of her claimed community interest and no distinction can be drawn between the principal portion of the settlement relating to real estate and securities and the accumulated dividends thereon under the principle established in *Lyeth v. Hoey,* 59 S. Ct. 155, 305 U. S. 188, 83 L. Ed. 119; and

(2) Although an amount of Five Thousand Four Hundred Fifty ($5450.00) Dollars was received by Appellant, it cannot constitute a taxable distribution of income from a testamentary trust because under

the decisions of the Supreme and Appellate Courts of this state, an income beneficiary of a testamentary trust is not entitled to any income intervening between the date of death and the date of the creation of the testamentary trust, and, accordingly, Appellant cannot be held to have received income from a trust which had no existence at the time the dividends were paid.

Dated, San Francisco,
September 24, 1943.

Respectfully submitted,
L. W. WRIXON,
Attorney for Appellant.

(Appendix Follows.)

Appendix.

Appendix

Exhibit A

Statement Showing Disposition of Property Originally Bequeathed in Trust by Will of Prentis Cobb Hale, Sr.

	Bequeathed to Trust per Article XIII of Will (R. 45, 46)	Distribution per Agreement June 18, 1937		
		To Appellant Per Article 1 (R. 40)	To Prentis Cobb Hale, Jr. per Art. 3 (R. 41)	To Testamentary Trust per Art. 2 (R. 41)
rpus				
me & Bldg. at 2430 nd 2446 Vallejo St., an Francisco	1.00(a)	1.00		
odside Real Property	1.00(a)	1.00		
sta Springs Real roperty	1.00(a)	1.00		
e Bros. Stores, Inc.	18,000 sh.	8,000 sh.		10,000 sh.
nsamerica Corp.	8,000 sh.	2,000 sh.	6,000 sh.	
e Real Estate Company	200 sh.	150 sh.		50 sh.
st National Bank of an Jose–200 shs. These iares were disposed of y Testator prior to eath				
me				
idends on Securities	14,320.00	6,230.00(b)	2,640.00(c)	5,450.00(d)

) Nominal values used merely to illustrate person to whom property is distributed under agreement of June 18, 1937 (R. 40)

) Distributed per Article 8 of Agreement dated June 18, 1937 (R. 42, 43)

) Distributed per Article 9 of Agreement dated June 18, 1937 (R. 43, 44)

) Distributed by Testamentary Trustee to Appellant, but not pursuant to Agreement dated June 18,

Sec. 22 (b) (3) of the Revenue Act of 1936 reads as follows:

> "The following items shall not be included in gross income and shall be exempt from taxation under this title:
>
> "(3) The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);"

Sec. 162 (c) of the Revenue Act of 1936 reads as follows:

> "(c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is property paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary."